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SMALL BUSINESS ADMINISTRATION

Loan Accounting and Other Financial Management Issues Impair Accountability

Statement of Linda M. Calbom, Director
Financial Management and Assurance

GAO
Accountability ★ Integrity ★ Reliability

GAO-03-676T

Highlights

Highlights of GAO-03-676T, a testimony before the Subcommittee on Government Efficiency and Financial Management, Government Reform Committee, House of Representatives

Why GAO Did This Study

Recently, the Small Business Administration's (SBA) auditors withdrew their unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements and issued disclaimers of opinion. The auditors also issued a disclaimer of opinion on SBA's fiscal year 2002 financial statements. This turn of events was primarily due to flaws in the way SBA accounted for its loan sales and for the remaining portfolio. There were also several other issues affecting SBA's fiscal year 2002 audit, including key internal control weaknesses and systems that did not substantially comply with the Federal Financial Management Improvement Act. The information GAO presents in this testimony, which is discussed in greater detail in our January 2003 report, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain* (GAO-03-87), is intended to assist Congress in assessing the current status of financial accountability at SBA.

What GAO Recommends

GAO is not making new recommendations in this testimony, but in a past report has made specific recommendations aimed at addressing the deficiencies in the accounting for loan asset sales and the remaining portfolio.

www.gao.gov/cgi-bin/getrpt?GAO-03-676T.

To view the full testimony, click on the link above.
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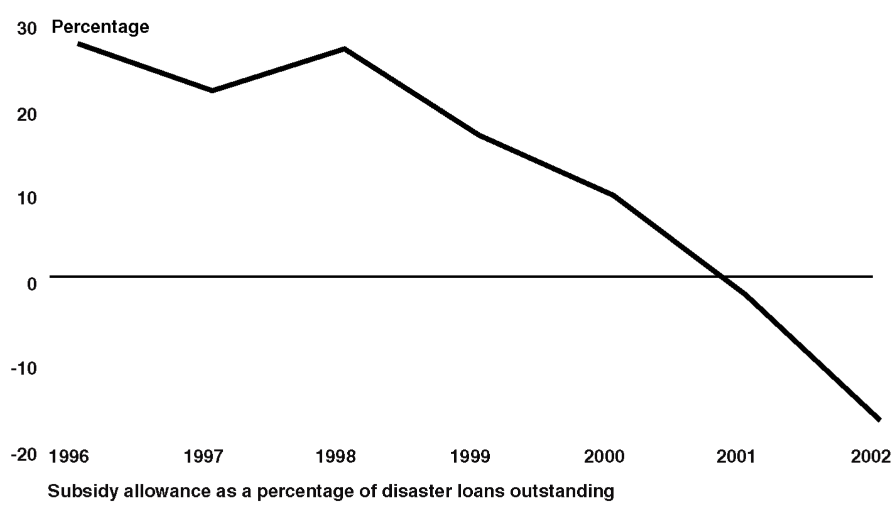
What GAO Found

Since August 1999, SBA held seven loan asset sales, disposing of a total of $5.8 billion in disaster assistance and business loans. Our review of the budgeting and accounting for the first five loan sales found errors that could significantly affect the reported results in SBA's budget and financial statements. We found that SBA (1) incorrectly calculated losses on loan sales reported in the footnotes to its financial statements, (2) did not appropriately consider the effect of loan sales on its estimates of the cost of the remaining portfolio, which could significantly affect its budget and financial statement reporting, and (3) had significant unexplained declines in its subsidy allowance for the disaster loan program. As shown in the figure, the subsidy allowance eventually declined to a negative balance, which indicated that SBA expected profits on its subsidized disaster loans.

Despite these errors and uncertainties, SBA's auditor gave unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements. We discussed these issues with SBA's auditors, who have since reassessed the unusual balance in the subsidy allowance account and withdrawn their unqualified audit opinions on the fiscal year 2000 and 2001 financial statements. The agency's inability to properly account for its loans sold and not sold, combined with several other financial management issues, led the auditors to issue a disclaimer of opinion on SBA's fiscal year 2002 financial statements. Until SBA corrects its financial management deficiencies, the agency's financial accounting and budgetary reporting will be unreliable. Based on recent discussions with SBA officials, we understand that they are making progress in identifying the sources of the loan accounting problems and in determining corrective actions.

SBA Disaster Loans Subsidy Allowance



Source: GAO.

Note: Analysis based on SBA data.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the status of financial management at the Small Business Administration (SBA). Recently SBA's auditor withdrew its unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements and issued disclaimers of opinion. The auditor also issued a disclaimer of opinion on SBA's fiscal year 2002 financial statements. This turn of events was primarily due to flaws we identified in the way SBA accounted for its loan sales and for the remaining portfolio. There were also several other issues affecting SBA's fiscal year 2002 financial statement audit, including key internal control weaknesses and systems that did not substantially comply with the Federal Financial Management Improvement Act (FFMIA). I will discuss all of these issues today which, when combined, point to an overall lack of financial accountability at SBA.

SBA's Accounting for Loan Sales and the Remaining Portfolio was Flawed

This January, we reported[1] that SBA had sold almost 110,000 loans with an unpaid principal balance of about $4.4 billion in five loan sales from August 1999 through January 2002.[2] Our review of the budgeting and accounting for these loan sales found errors that could significantly affect the reported results in SBA's budget and financial statements.

[1] U.S. General Accounting Office, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain*, GAO-03-87 (Washington, D.C.: Jan. 3, 2003).

[2] SBA has held two additional loan sales that were not included in our review. In August 2002, SBA held its sixth sale, which included about 30,000 loans with an outstanding balance of $657 million. The seventh sale took place in December 2002 and consisted of about 29,000 loans with an outstanding balance of $682 million. In all seven sales SBA has sold about 169,000 loans with an outstanding balance of $5.8 billion.

We found that SBA (1) incorrectly calculated losses on loan sales reported in the footnotes to its financial statements, (2) did not appropriately consider the effect of loan sales on its estimates of the cost of the remaining portfolio, which could significantly affect its budget and financial statement reporting, and (3) had significant unexplained declines in its subsidy allowance[3] for the disaster loan program. Until SBA makes the necessary corrections to its procedures to estimate the cost of its credit programs, including the effect of its loan sales, the reliability of the current and future subsidy rates will remain unknown. We understand that SBA is taking steps to address the issues we identified, including working with a consulting firm to perform a detailed analysis of its loan sale accounting and cost estimation procedures.

SBA Improperly Calculated Losses on Loan Sales

Accounting records related to SBA's first five loan sales indicated that losses exceeded $1.5 billion. However, this amount is overstated because of errors in the way SBA calculated the losses. Because of the lack of reliable financial data, we were unable to determine the financial effect of loan sales on SBA's budget and financial statements. These errors raise serious concerns about the information related to the results of loan sales included in the footnotes to the annual financial statements that SBA provided to the Office of Management and Budget (OMB) and the Congress for decision-making purposes.

[3] For a subsidized loan program, the subsidy allowance account generally represents the subsidized portion – the amount of expected losses related to estimated defaults and financing costs from making below-market rate loans – assumed by the federal government. The subsidy allowance account is subtracted from the loans receivable balance on the balance sheet to arrive at the net loan amount expected to be repaid.

For accounting purposes, the gain or loss on a loan sale represents the difference between the net book value (the outstanding loans receivable balance minus the subsidy allowance) of the loans sold and the net sale proceeds.[4] The footnotes to SBA's fiscal year 1999 and 2000 financial statements reported accounting losses of $75 million and $600 million, respectively, on its loan sales. SBA did not separately disclose the losses calculated on the two loan sales that took place during fiscal year 2001.[5] According to SBA's accounting records, the first five sales resulted in total losses of more than $1.5 billion.

Prior to a loan sale, an estimate of the loans' current value to the government or "hold value" is calculated to determine what the loans are worth to the government in the event that the loans are held to maturity or some other resolution, such as prepayment or default.[6] This hold value is compared to an estimate of the expected net sale proceeds to determine if it is advantageous for the loans to be sold.[7] After a sale, the hold value is compared to the actual net sale proceeds to determine whether or not and by how much the government benefited from the sale. SBA determined that the first five loan sales resulted in a $606 million benefit to the government.[8] This benefit calculation differs from the accounting gain or loss because the benefit calculation is not designed to take into consideration changes in interest rates from the time the loans were disbursed to the date of the sale, while the accounting gain or loss, if properly computed, does take these changes into account.

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[4] OMB Circular A-11 defines net sale proceeds in the context of loan sales as the amounts paid by purchasers less all seller transaction costs (such as underwriting, rating agency, legal, financial advisory, and due diligence fees) that are paid out of the gross sales proceeds rather than paid as direct obligations by the agency.

[5] SBA also did not disclose any gain or loss on the two loan sales, number 5 and 6, which took place during fiscal year 2002 in its financial statements for that year.

[6] The hold value is calculated on a present value basis, meaning the worth of a future stream of returns or costs in terms of money paid immediately. In calculating the hold value, interest rates from the most recent President's budget at the time the estimate is prepared provide the basis for converting future amounts into their "money now," or present value, equivalents.

[7] OMB reviews these calculations as part of its approval process for SBA to conduct a loan sale.

[8] We did not audit the data used to calculate the hold values for each sale, and therefore did not conclude on the reasonableness of the hold values for any of the sales.

We reviewed the methodology SBA used to calculate the results of its loan sales for accounting purposes and found significant errors. When calculating whether loans are sold at a gain or a loss, agencies must estimate the portion of the subsidy allowance to allocate to each loan sold in order to calculate the net book value for those loans. Since SBA's calculation of the net book value of the loans sold exceeded the net proceeds from the sales, losses were calculated. Our review of these calculations found that SBA's estimates did not consider all the appropriate cash flows when allocating the subsidy allowance to the sold loans. For example, when calculating the gains or losses for the disaster loan program, SBA failed to allocate a portion of the subsidy allowance for financing costs associated with lending to borrowers at below market interest rates. Doing so would have reduced the amount of loss that SBA reported on the loan sales.

In addition, SBA incorrectly allocated the subsidy allowance for the previously defaulted 7(a) and 504 guaranteed loans, which could materially distort the gain or loss. SBA used its estimated net default cost, which considers first the probability of default and then the estimated recovery rate after default. For example, if a $10,000 guaranteed loan has an estimated default rate of 10 percent and an estimated recovery rate of 50 percent, the subsidy allowance allocated by SBA would be $500 ([$10,000 x .10] x .50). Therefore, the net book value calculated for the loan would be $9,500. However, since guaranteed loans sold have already defaulted, it is not appropriate to apply the estimated default rate of 10 percent. SBA should have applied only the estimated recovery rate of 50 percent for these loans, and the subsidy allowance allocated would be $5,000 ($10,000 x .50) and the net book value calculated for the loan would be $5,000. Figure 1 illustrates the difference in the calculated gain or loss resulting from this error if the previously defaulted loan were sold for $6,500. The left column, based on SBA's incorrect methodology, shows that the loan was sold for a $3,000 loss, while the right column appropriately allocates the allowance based on expected recoveries and results in a $1,500 gain, a difference of $4,500 for this example of a $10,000 guaranteed loan sold.

Figure 1: Gain / Loss Calculation on Previously Defaulted Guaranteed Loans Sold

Dollars

SBA's method		Correct method	
Previously defaulted loan guarantee	$10,000	Previously defaulted loan guarantee	$10,000
Less allowance based on net defaults (defaults less recoveries)	500	Less allowance based on portion not expected to be recovered	5,000
Net book value	9,500	Net book value	5,000
Net sale proceeds	6,500	Net sale proceeds	6,500
Loss	**($3,000)**	**Gain**	**$1,500**

Source: GAO analysis.

SBA's errors in calculating the losses on disaster loans and previously defaulted guaranteed loans sold both resulted in overestimates of the net book value of the loans sold and the losses that SBA reported in the footnotes to its fiscal year 1999 and 2000 financial statements. Because of the way the results of loan sales are incorporated in the budget and the financial statements, the reestimates, if done properly, should have corrected the impact of these errors. However, as I discuss next, the reestimates were not reliable.

Subsidy Cost Reestimates are Unreliable

SBA did not conduct key analyses of the loans sold and those remaining in its portfolio so it could determine how the sales affected its reestimates of program costs for its remaining loans. OMB's budget guidance directs agencies to make reestimates for all changes in cash flow assumptions in order to adjust the subsidy estimate for differences between the original estimated cash flows and the actual cash flows. SBA officials acknowledged that analyses of the impact of loan sales on its historical averages should be done. However, they told us they lacked the appropriate historical data and resources to perform these analyses. Because SBA did not assess the effect loan sales would have on its historical averages of loan performance, such as when loans default or prepay, the agency did not know whether these averages, which can significantly affect the estimated cost of a loan program, reasonably predict future loan performance. As a result, information in both the budget and financial statements related to the reestimated cost of SBA's loan programs cannot be relied upon.

SBA is generally required to update or "reestimate" loan program costs annually. OMB Circular A-11 directs agencies to do reestimates for all changes in cash flow assumptions. Thus, reestimates should include all aspects of the original cost estimate, including prepayments, defaults, delinquencies, and recoveries. These reestimates are done to adjust the subsidy cost estimate for differences between the original cash flow projections and the amount and timing of cash flows that are expected based on actual experience, new forecasts about future economic conditions, and other events that affect the cash flows.

Even after selling about $4.4 billion of loans, nearly half of its loan portfolio, SBA had not analyzed the effect of loan sales on the estimated cost of the remaining loans in its portfolio. SBA officials told us loans are selected for sale based on certain criteria, such as where the loan is located or serviced, the type of collateral, or whether the loan is performing. Since the loan selection process is not random—that is, all loans do not have an equal chance of being selected—it is likely that the loans sold had different characteristics than the portfolio's historical averages prior to sales. Consequently, the characteristics of the remaining loans may also differ substantially from the portfolio historical averages prior to the sales. For example, during our analysis of the loans that were sold, we determined that 84 percent of the $3.8 billion of disaster loans sold were performing–meaning that payments were not more than 30 days delinquent. Selling mostly performing loans could leave a disproportionate level of nonperforming loans in SBA's portfolio. Because SBA had not analyzed the effect of loan sales on the characteristics of its remaining portfolio, it does not know if the percentages of remaining performing and nonperforming loans are different from the historical averages prior to the sales. A change in these percentages could indicate that expected defaults in the remaining portfolio could be higher or lower than current assumptions, based on historical data, suggest.

Another important loan characteristic is the stated loan term. This term is the contractual amount of time borrowers have to repay their loans. SBA's estimated costs of the disaster loan program are based on historical average loan term assumptions of 16 years for business disaster loans and 17 years for home disaster loans. Based on our review of the disaster loans sold in the first five sales, the average loan term was about 25 years. However, SBA continued to use average loan term assumptions of 16 and 17 years in its reestimates without doing the appropriate analysis to determine whether these assumptions were still valid. Based on our recent discussion with SBA officials, their detailed analysis of the cost estimation procedures for the disaster loan program found that, among other things, the average loan term assumption should have been greater. Relatively minor changes in some cash flow assumptions, such as higher or lower default and recovery rates and changes in loan terms, can significantly affect the estimated cost of the loan program and therefore the program's budget.

The Subsidy Allowance Account Was Misstated

During our review of the accounting for loan sales, we noted that the subsidy allowance account for the disaster loan program had an unusually low balance. For a subsidized loan program, the subsidy allowance account is generally the amount of expected losses on a group of loans related to estimated defaults and financing costs from making below-market rate loans. In effect, the subsidy allowance is the cost associated with the loans that SBA does not expect to recover from borrowers. For financial reporting purposes, the subsidy allowance reduces the outstanding loans receivable balance to the amount that SBA expects to collect from borrowers, known as the net loans receivable balance (or net book value), which is shown on the balance sheet.

Table 1 summarizes the disaster loan program's reported outstanding loans receivable balance, the subsidy allowance balance, the net book value, and the subsidy allowance as a percentage of the loans receivable balance for fiscal years 1998 through 2002. The reported subsidy allowance compared to the loans receivable balance decreased significantly in fiscal years 2000 and 2001, to the point of showing that the remaining portfolio of the disaster program was expected to generate a profit. This declining trend continued into fiscal year 2002. SBA could not provide support for the balance or explain the reason for this anomaly.

Table 1: Reported Loans Receivable Balances of SBA's Disaster Loan Program

Dollars in millions

Disaster loan program	Fiscal year 1998	Fiscal year 1999	Fiscal year 2000	Fiscal year 2001	Fiscal year 2002
Loans receivable Outstanding	$5,614	$5,659	$5,305	$3,293	$3,110
Less / (plus): subsidy allowance balance	$1,502	$929	$505	($77)	($522)
Net book value	$4,112	$4,730	$4,800	$3,370	$3,632
Subsidy allowance as a percentage of loans receivable balance	26.8%	16.4%	9.5%	(2.3%)	(16.8%)

Source: SBA.

Table 1 shows a rapid decrease in the reported subsidy allowance between fiscal year 2000 and 2001. Most of this decrease actually occurred in fiscal year 2000, but was masked by an adjustment made during the fiscal year 2000 financial statement audit. Before SBA made the audit adjustment, the subsidy allowance for the disaster program was about $91 million for fiscal year 2000. This balance was $838 million, or about 90 percent, less than the $929 million balance for fiscal year 1999, while loans receivable outstanding decreased by only $354 million, or about 6 percent.

In order to restore the subsidy allowance to a more reasonable balance at the end of fiscal year 2000, in agreement with its auditor, SBA increased the subsidy allowance balance by recording an audit adjustment that was essentially meant to reflect the expected impact of loan sales on the reestimates prepared in fiscal year 2000, which did not factor in the effects of loan sales.[9] This increased the reported cost of the disaster loan program by $414 million in fiscal year 2000. Since the amount of the adjustment was based on SBA's erroneous calculations of loan sale losses, as previously discussed, the amount of the adjustment was incorrect. During fiscal year 2001, SBA reversed the audit adjustment and revised its reestimates to include cash flows related to loan sales. Our review of the fiscal year 2001 disaster loan program reestimates indicated that loan sales increased the reported cost of the program by about $292 million. However, this amount is also likely misstated because, as I previously mentioned, the reestimates did not consider the specific characteristics of the loans sold or the loans remaining in the portfolio.

[9] Theoretically, had the reestimates factored in the loan sales, the subsidy allowance account would have been appropriately adjusted, regardless of any errors made in recording the calculated accounting losses.

The unexplained decline in the subsidy allowance continued in the fiscal year 2001 financial statements where SBA reported a negative balance in the subsidy allowance for the disaster loan program. As shown in table 1, this allowance account no longer reduced the amount SBA expected borrowers to repay – it actually increased the expected repayments from borrowers and indicated that the loan program was profitable. However, because the program is subsidized, with estimated default and financing costs exceeding the amount of interest borrowers are expected to pay, it should not show an expected profit, and thus the balance for the subsidy allowance account appears to be significantly misstated.[10] As in the prior year, SBA could not explain the unusual balance. Based on our review of SBA's fiscal year 2002 financial statements, the unexplained trend continued and the negative balance of the subsidy allowance (expected profit) increased to $522 million.

While the objective of our work was not to determine the specific cause of the unusual balance, several possibilities exist. As previously mentioned, not considering the characteristics of the loans sold or of those remaining in SBA's portfolio could contribute to the unusual balance. Another possibility is that SBA may have underestimated the cost of its disaster loan program because the cash flow assumptions used to estimate the subsidy cost did not reflect the true characteristics or performance of its loan portfolio. For example, as I previously discussed, SBA used average loan term assumptions of 16 and 17 years to estimate the cost of the disaster loan program. However, based on recent discussions with SBA officials, they have found that the average loan term should have been greater. Underestimating the loan term would mean that SBA did not put enough into the subsidy allowance account to cover interest costs associated with these loans and the subsidy allowance would be depleted as these costs were written off against it until there was a negative balance. From a budgetary perspective, this could mean that SBA did not request an appropriation large enough to cover the cost of the loan program.

Despite the significant, unexplained decline in the subsidy allowance and the errors in calculating the losses on loan sales, SBA received unqualified or "clean" audit opinions on its fiscal year 2000 and 2001 financial statements. An unqualified audit opinion indicates that the balances in the

[10] Based on SBA's reestimates for its fiscal year 2001 financial statements, the subsidy cost of this program ranged from $17 to $33 for every $100 the federal government lends, depending on the interest rates in effect when the loans were made.

financial statements are free of significant errors, known as material misstatements. As previously mentioned, SBA's auditor attempted to adjust the anomalies in the subsidy allowance during the fiscal year 2000 financial statement audit. However, the adjustment was based on the previously described erroneous loss calculation. For the fiscal year 2001 audit, SBA's auditor performed a number of audit procedures related to the disaster loan program subsidy allowance account. For example, the auditor evaluated the methodology and formulas used to calculate reestimates, assessed data used to calculate key cash flow assumptions, and reviewed various internal controls over the subsidy estimation process. However, this work did not appear to focus on determining the cause of the unusual negative balance of the account, which, contrary to the fact that this is a subsidized loan program, would indicate that these loans were expected to generate a profit. The auditor's workpapers indicated that the auditor had agreed, in discussions with SBA management, that if the "methodology and data were materially correct, we [the auditor] would conclude that the resulting subsidy reserve [allowance] would be materially correct for financial statement reporting purposes." The workpapers also indicated that, "whatever the results of the reestimates are, as long as the methodology is sound and supportable, we [the auditor] would not consider the balance [of the subsidy allowance] anything other than 'natural.'"

Although SBA's auditor may have recognized some of the errors we identified, they did not determine the cause of the unusual balance and propose the necessary audit adjustments or modify their audit report as appropriate. In such situations, when auditors cannot determine whether a balance is fairly stated because sufficient reliable supporting documentation is not available, audit standards[11] call for auditors to either qualify their opinion with the noted exception or issue a disclaimer of opinion, meaning that the auditor was unable to obtain satisfaction that the financial statements are fairly stated and therefore does not express an opinion. We discussed these issues with SBA's auditor and they have since reevaluated and withdrawn their unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements and issued disclaimers of opinion.

In response to our findings, SBA contracted with an independent consulting firm to complete a more detailed analysis of its loan sale accounting and cost estimation procedures to determine the cause of the

[11] Statements on Auditing Standards, AU §508 paragraphs 22 and 23.

unusual balance in the subsidy allowance account. We recently met with SBA officials to discuss the steps taken to date to address the issues we identified. We understand that SBA, working with the consultants, has identified a number of issues related to the methods and assumptions used to estimate the cost for the disaster loan program. While we have not had an opportunity to analyze their findings in detail, based on our previous work, several of the issues they identified, including the understated average loan term, appear to be plausible causes of the decline in the subsidy allowance for the disaster loan program.

Results of Fiscal Year 2002 Financial Statement Audit

SBA's inability to account for its loan sales or adequately reestimate the cost of loans not sold, combined with other financial management issues, led to the auditors issuing a disclaimer of opinion on SBA's fiscal year 2002 financial statements. I will now briefly discuss the disclaimer of opinion, the internal control weaknesses they reflect, and the consequences of these weaknesses regarding compliance with FFMIA.

Disclaimer of Opinion

The disclaimer of opinion for fiscal year 2002 was primarily due to three issues: (1) SBA's disaster loan modeling contained deficiencies and was no longer adequate for determining the costs of disaster loans sold or reestimating the cost of loans not sold, (2) SBA did not present future expected default costs on pre-1992 loan guarantees[12] or determine the correct valuation of related balances, and (3) SBA could not ensure that the balance in the Master Reserve Fund[13] residual asset or liability was reliable.

As I've previously discussed, SBA's inability to determine the cost of loans sold or adequately reestimate the cost of loans not sold could materially affect amounts reported in the budget and the financial statements. SBA and its consultants had not completed their analysis of SBA's loan sale accounting and cost estimation procedures prior to the completion of the fiscal year 2002 audit. Therefore, SBA was not able to provide sufficient

[12] Pre-1992 loan guarantees are loan guarantees committed prior to October 1, 1991. The accounting standard requires that the liabilities of pre-1992 loan guarantees be recognized when it is more likely than not that the loan guarantees will require a future cash outlaw to pay default claims.

[13] The 7(a) secondary market program, one of SBA's business loan programs, is administered by an agent of SBA. Payments for this program flow through the Master Reserve Fund.

evidence to its auditors to support certain amounts reported and disclosures made in its fiscal year 2001 and 2002 financial statements, thereby limiting the scope of the audit and leading to the disclaimer of opinion.

Additionally, SBA did not present future expected default costs on pre-1992 loan guarantees. SBA made several adjusting entries to both the fiscal year 2002 and fiscal year 2001 financial statements in an effort to correct this. However, SBA did not have a calculation methodology to determine its expected future default costs and related liability or to support the adjustments made. Therefore, SBA could not provide sufficient documentation that the liability balance of $116 million as of September 30, 2002, was fairly stated.

The final issue contributing to SBA's disclaimer related to the Master Reserve Fund. SBA's fiscal and transfer agent maintains the Master Reserve Fund to facilitate operation of the secondary market program[14] for 7(a) Business Loans, a loan guarantee program for small businesses that would otherwise be unable to obtain financing at reasonable rates. The Master Reserve Fund receives payments from lenders who have SBA-guaranteed loans and makes payments to the investors in the secondary market program. In fiscal year 2002, SBA estimated that there was a potential future deficit (shortfall resulting from payments to investors exceeding payments from lenders) in the range of zero to $18.3 million required to liquidate the obligations in the 7(a) secondary market. This potential deficit contrasted with fiscal year 2001 where an estimated excess of $68 million was reported.

According to SBA's auditor, SBA used samples of Master Reserve Fund activity for fiscal years 2002 and fiscal year 2001 to estimate the year-end balances. The samples were small and differed in important respects from the total population of loans. Thus, the sampling was not entirely representative of the loan population and did not provide sufficient evidence that the estimate of the Master Reserve Fund balance was fairly stated.

[14] The secondary market program was created to increase the attractiveness of small business lending to the lending community. Through this market, lenders are able to sell the guaranteed portion of SBA guaranteed loans to investors, thereby improving the lenders' liquidity and increasing the yield on the nonguaranteed portion of the SBA loan.

Internal Control Weaknesses

The study and evaluation of the system of internal control over financial reporting are included as part of the financial statement audit under generally accepted auditing standards. Internal control is an integral component of an agency's management that provides reasonable assurance that the following objectives are being achieved: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.[15] Internal control serves as the first line of defense in safeguarding assets and in preventing and detecting errors and fraud. As federal policymakers and program managers continually seek to better achieve agencies' missions and program results, they seek ways to improve accountability. A key factor in achieving these outcomes and minimizing operational problems is the implementation of appropriate internal control.

Internal control over financial information is evaluated during the audit, and the auditor is required to communicate to the agency any condition that represents a significant deficiency in internal controls—referred to as a reportable condition.[16] A material internal control weakness is a reportable condition that does not reduce to a relatively low level the risk that errors, fraud, or noncompliance involving significant amounts may occur and not be detected in a timely manner by employees in the normal course of performing their assigned functions. SBA's auditor identified five material weaknesses and one reportable condition.

As I previously stated, SBA received a disclaimer of opinion from its auditor in fiscal year 2002 primarily due to three issues, and each of these issues resulted from a material weakness in their internal controls. SBA's auditor reported material weaknesses relating to (1) disaster loan modeling, (2) the liability for loan guarantees and related accounts for pre-1992 loan commitments, and (3) the Master Reserve Fund, all of which I have discussed. The fourth material weakness related to SBA's financial reporting process. According to SBA's auditor, SBA continued to experience widespread difficulties in producing complete, accurate, timely, and adequately supported draft and final financial statements, including

[15] *Standards for Internal Control in the Federal Government*, (GAO/AIMD-00-21.3.1) Washington, D.C.: November 1999)

[16] A reportable condition is a significant deficiency in the design or operation of internal controls that could adversely affect the organization's ability to provide reasonable assurance on the reliability of its financial reporting, performance reporting, and compliance with laws and regulations.

footnotes. The auditor stated that additional attention is needed to ensure that a fully effective quality assurance process is documented and in place. The auditor further stated that SBA's difficulties with financial reporting may be attributable to devoting insufficient resources to the process, particularly the quality control process.

The fifth material weakness was due to funds control weaknesses. For example, the auditor reported that SBA established invalid undelivered orders in its liquidating funds and did not return all unobligated balances in its liquidating funds to the general fund at the end of the fiscal year. Also, SBA did not have sufficient funds controls in place to ensure that payments for defaulted 7(a) loan guarantees did not exceed authorized amounts or to ensure that obligations were not incurred against anticipated budgetary resources. These shortcomings increase the risk that SBA may violate the Antideficiency Act.[17]

Finally, while SBA has continued to improve internal controls over its information system environment in certain areas, the auditor reported that further improvement is needed to ensure a sound information system control environment. This internal control deficiency was included as a reportable condition in the auditor’s 2002 report on internal controls. Weaknesses were reported in all six categories of general computer controls.[18] General computer controls create the environment in which application systems and controls operate. During a financial statement audit, the auditor focuses on general controls for the agency’s major computer facilities and systems supporting a number of different computer applications, such as major data processing installations or local area networks. If general computer controls are weak, as is the case at SBA, they severely diminish the reliability of controls associated with individual applications.

[17] The Antideficiency Act, among other things, prohibits the making of expenditures or the incurring of obligations prior to or in excess of appropriations.

[18] The six general control categories are: (1) entity-wide security program control, (2) access control, (3) application software development and program change control, (4) system software control, (5) segregation-of-duty control, and (6) service continuity control.

Federal Financial Management Improvement Act of 1996

SBA's auditor also concluded that SBA's systems did not substantially comply with the Federal Financial Management Improvement Act of 1996 (FFMIA). FFMIA is a measure of an agency's ability to incorporate into its financial management system accounting standards and reporting objectives established for the federal government, so that all assets, liabilities, revenues, expenses, and the full costs of programs and activities can be consistently and accurately recorded, monitored, and uniformly reported. Substantial noncompliance with FFMIA indicates that SBA's financial management systems do not routinely provide reliable, useful, timely, and consistent information to fulfill its responsibility of being accountable to the public and of providing timely financial information to manage on a day-to-day basis.

SBA's financial management systems in fiscal year 2002 did not substantially comply with all three aspects of FFMIA: (1) federal financial management systems requirements, (2) federal accounting standards, or (3) the U.S. government standard general ledger (SGL) at the transaction level.

SBA's auditor noted that SBA was not in substantial compliance with federal financial management systems requirements because its core financial system is not able to provide complete, reliable, timely and consistent financial information on programs to enable management to fulfill its responsibility to the public and to provide timely information for managing current operations. Also, access control, segregation-of-duties, and other general control weaknesses exist in SBA's information systems controls. Additionally, funds control deficiencies exist as is evidenced in SBA's material weakness in that area.

The auditor concluded that SBA did not substantially comply with federal accounting standards because it cannot support the reported cost of loans sold, the reestimates of the subsidy for loans not sold, or the liability for pre-1992 loan guarantees. SBA also cannot support the balance in the Master Reserve Fund.

Finally SBA's auditor concluded that SBA's financial systems did not substantially comply with the SGL at the transaction level. During fiscal year 2002, SBA modified its Financial Reporting Information System but did not detect in a timely manner an error created by the modification. SBA also experienced problems that resulted in the posting of invalid information to the system when it converted to its current Oracle-based administrative accounting system.

In closing, Mr. Chairman, SBA's financial management deficiencies are quite severe and point to an inability to provide full accountability for taxpayer funds provided to the agency for carrying out its programs. Until these deficiencies are corrected, SBA's financial accounting and budgetary reporting will be unreliable. In our January 2003 report, we made a number of recommendations to SBA covering these matters related to accounting for loan sales. SBA agreed with our recommendations, and we understand that they are making progress identifying potential causes of these deficiencies and actions to address them. We look forward to assessing the results of these activities.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other members of the subcommittee may have.

Contact and Acknowledgments

For information about this statement, please contact Linda Calbom, Director, Financial Management and Assurance, at (202) 512-9508, or Julia Duquette, Assistant Director, at (202) 512-5131. You may also reach them by e-mail at calboml@gao.gov or duquettej@gao.gov. Other individuals who made key contributions to this testimony include Marcia Carlsen and Lisa Crye. Numerous other individuals made contributions to the work supporting this testimony.

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